August 2019

OECD Work Program to Address the Digitalized Economy

On May 31, 2019, as one of the main areas of focus of the ongoing work on the Base Erosion and Profit Shifting ("**BEPS**") project, Members of the OECD/G20 Inclusive Framework on BEPS ("**Framework**") took a major step forward with the agreement on the Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy. This Programme of Work provides detailed instructions to the Framework and its technical working groups to deliver a solution to the tax challenges brought by digitalization. This work focuses on two pillars:

- The first pillar relates to the allocation of taxing rights, and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules
- The second pillar focuses on the remaining BEPS issues, and seeks to develop rules that would provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

Pillar 1: Revised Profit-Allocation and Nexus Rules

Three proposals were articulated to develop a consensus-based solution on how taxing rights on income generated from cross-border activities in the digital age should be allocated among jurisdictions:

- user participation (in media through user-generated content and social networking)

- marketing intangibles; and
- significant economic presence.

The work program sets out the necessary steps to develop the proposals:

- different approaches to determine the amount of profits subject to the new taxing right and the allocation of those profits among jurisdictions;
- a new nexus rule that includes a concept of taxable business presence in a market jurisdiction without physical presence requirements; and
- full implementation and efficient administration of any new taxing right, including the effective elimination of double taxation and the resolution of tax disputes.

New Profit-Allocation Rules

Three different methods are under consideration:

- Modified residual profit-split ("**MRPS**") method: the MRPS method allocates a portion of an MNE group's non-routine profit to jurisdictions to reflect the value created in markets that is not recognized under the existing profit allocation rules. It involves four steps: (i) determine total profit to be split; (ii) remove routine profit, using either current transfer pricing rules or simplified conventions; (iii) determine the portion of the non-routine profit that is within the scope of the new taxing right, using either current transfer pricing rules or simplified conventions; and (iv) allocate such in-scope non-routine profit to the relevant market jurisdictions, using an allocation key.
- Fractional apportionment method: The amount subject to a new taxing right is calculated by determining the profit to be allocated to market jurisdictions without any distinction between routine and non-routine profit, and by selecting allocation keys such as location of employees, assets, sales, or users.

- Distribution-based approaches: Simplified methods are being considered, including rules to specify a baseline of the profits attributable to marketing, distribution, and user-related activities, which would allocate a proportion of total (routine and non-routine) profits to market jurisdictions.

A number of other issues will be considered in determining the appropriate profit-allocation rules for a MNE group, including whether the rules should be applied based on business lines and/or geographic regions, and the treatment of losses.

New Nexus Rules

The development of new concepts to allow market jurisdictions to exercise taxing rights will be explored, including the following:

- remote taxable presence (without a traditional physical presence) and a new set of standards for identifying when such a remote taxable presence exists; and
- taxable income sourced in (derived from) a jurisdiction.

A new nexus rule could be achieved through the amended "permanent establishment" ("**PE**") definition in article 5 of the OECD model tax treaty: a PE may be deemed to exist if a group has a remote, yet sustained and significant, involvement in the economy of a country. Alternatively, a new stand-alone rule establishing a new nexus may be introduced.

Implementation of the New Taxing Right

Many issues related to the elimination of double taxation and the avoidance and resolution of disputes in relation to the new nexus and profit allocation rules must be considered. These issues are expected to include:

- The effectiveness of the existing treaty provisions and the need to develop new or enhanced, treaty provisions;
- The interaction between any new taxing right and existing taxing rights (such as withholding taxes on royalty payments or payments for services);

- The current dispute prevention and resolution procedures, in the context of the new nexus and profit allocation rules; and

- The consideration for multilaterally coordinated risk assessment in applying the new nexus and profit allocation rules.

Enforcement and collection arrangements will be considered, for example, if the tax liability is assigned to an entity that is not a resident of the taxing jurisdiction. Any changes are expected to result in the need for new data, documentation, and reporting obligations. One option being considered to assist with the administration of the new taxing rights is a system based on, and supplementary to, the existing framework and technology used for the exchange of country-by-country reports. Any necessary tax treaty changes may be effected through the Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting ("**MLI**") or through a new multilateral convention.

Pillar 2: Global Anti-Base-Erosion Proposal

The global anti-base erosion ("**GloBE**") proposal seeks to address remaining BEPS risk of profit shifting to entities subject to no or very low taxation. The proposal consists of two interrelated elements:

- an income inclusion rule that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate; and

- a tax on base eroding payments that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax), together with any necessary changes to double tax treaties, for certain payments unless that payment was subject to tax at or above a minimum rate.

Income Inclusion Rule

An income inclusion rule taxes the profits of a foreign-controlled entity or branch if that profit was subject to a low effective tax rate:

- A shareholder is required to bring into account a proportionate share of the profit of that company. The rule supplements existing controlled foreign company ("**CFC**") rules.

- A switchover rule that would allow the state of residence to apply the credit method instead of the exemption method where the profits attributable to a PE or derived from immovable property (which is not part of a PE) are subject to tax at an effective rate below the minimum rate.

The work program examines the use of a fixed-percentage tax rate for the minimum rate. It is contemplated that the rule would operate as a top-up to the minimum rate of tax, although low-taxed profits benefiting from a harmful preferential regime may be taxed at the higher of the minimum rate and the full domestic rate.

Additional areas identified for further exploration include:

- possible uses of carve-outs for regimes compliant with the OECD BEPS standard on harmful tax practices and in other circumstances;

- consideration of the effects of blending—that is, the mixing of high-tax and low-tax profits to arrive at a blended rate that is above the minimum rate;

- coordination with other international tax rules, including withholding taxes, transfer pricing, and CFC rules;

- coordination between countries if, for example, a tiered ownership structure involves several countries; and

- rules for ownership thresholds, the attribution of profits to shareholders, the calculation of tax paid on profits, and the calculation of investors' tax liability.

Tax on Base-Eroding Payments

The second element proposed sets out a tax on base-eroding payments:

- An undertaxed payments rule that would deny a deduction or impose source-based taxation for a payment made to a related party if that payment was not subject to tax at a minimum rate; and

- A complementary subject-to-tax rule is incorporated into tax treaties. The rule denies treaty relief otherwise available to undertaxed payments, such as relief under the interest and royalty articles.

Next Steps

A steering group will lead the overall project, various working parties will provide technical input, and the OECD secretariat will conduct the economic analysis and impact assessment of the proposals. There will likely be a stakeholder consultation in the fall, and a progress report is expected in December 2019. The goal is to achieve political agreement on the architecture of a consensus solution at the beginning of 2020. Work will continue on agreeing to the policy and technical details, and a final report is expected to be delivered by the end of 2020.

The changes, when agreed on, will require significant amendments to existing tax treaties, the OECD transfer pricing guidelines, rules for the attribution of profits to PEs, and domestic legislation. As a result, it is likely to be some time before any new rules are implemented effectively.

The work program will require significant resources from the 129 governments participating in the OECD Inclusive Framework. Key objectives for governments and business interests alike are that any new rules should be clear and provide certainty but avoid double taxation, and that there should be a consistent global framework that fosters international economic growth and cross-border trade.

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.